Daiwa Capital Markets

U.S. Economic Comment

- The U.S. economy: likely up in Q3; risks for Q4
- Powell: both optimistic and dovish
- Employment costs: limited response to the soft labor market

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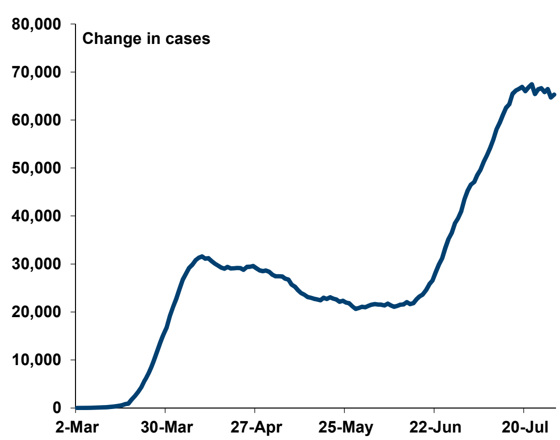
U.S. GDP: What about Q3? Q4?

Let's not dwell on the second quarter. As widely expected, the performance of the U.S. economy was dismal (off 32.9 percent, easily eclipsing the previous record drop of 10.0 percent). We learned that locking down consumers and closing certain businesses will lead to pronounced contractions. The issue now is what lies ahead.

As noted in the latest policy statement of the Federal Open Market Committee, the outlook for the economy depends significantly on the course of the virus, and in this regard, the recent acceleration in the number of Covid cases stirs concern (chart, left). While risks to the outlook have shifted to the downside, two factors lead us to remain hopeful that the economy will remain on track. First, the upward trend in the number of new Covid cases seems to have drawn to a close, and greater efforts by the public to limit the spread of the virus might soon lead to a downward trend. Second, the reactions of businesses and consumers to the acceleration in the number of Covid cases have been less pronounced than the adjustments in the spring. Individuals and business executives seem to be finding ways to deal with the virus other than by shutting down. We can perhaps soon add a third factor supporting an optimistic view: Congress might add another round of fiscal stimulus.

The moderate response of businesses and individuals to the recent pickup in Covid cases is evident in various high-frequency economic statistics (i.e. daily or weekly data released with short lags). Most such series collapsed in the spring when the virus first became an issue, but recently they have largely held steady after inching higher in May and early June.

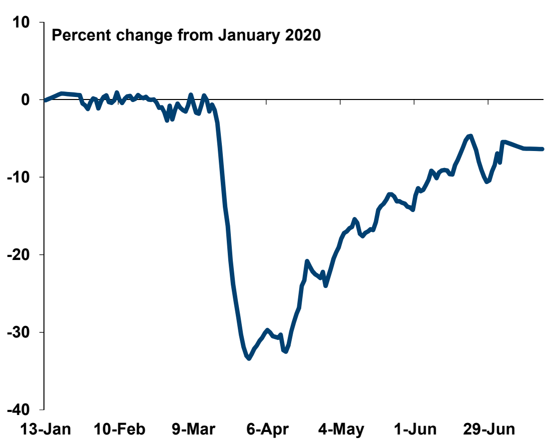
New Covid-19 Cases in the United States*



Seven-day moving average.

Source: Johns Hopkins University and Medicine Coronavirus Resource Center via Bloomberg

Percent Change in Consumer Spending*



** Change in average consumer credit and debit card spending, indexed to January 4-31 2020 and seasonally adjusted. This series is based on data from Affinity Solutions.*

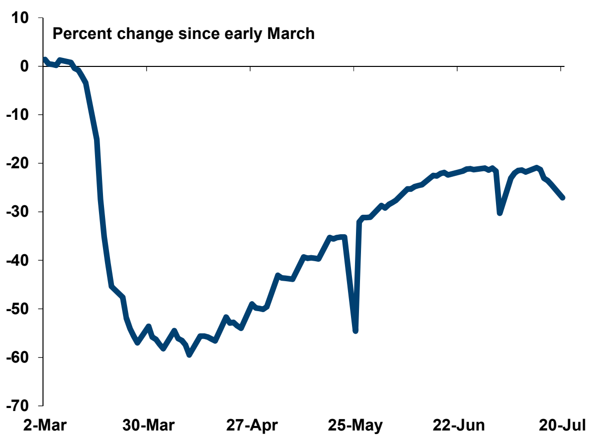
Source: "How Did COVID-19 and Stabilization Policies Affect Spending and Employment? A New Real-Time Economic Tracker Based on Private Sector Data", by Raj Chetty, John Friedman, Nathaniel Hendren, Michael Stepner, and the Opportunity Insights Team. June 2020. Available at: https://opportunityinsights.org/wp-content/uploads/2020/05/tracker_paper.pdf

For example, the number of individuals traveling on an airplane on a typical day fell from approximately 2.0 million at the start of the year to an average of about 100,000 in April. That total moved to about 650,000 in the first half of July, and it has held that average in the past two weeks. Similarly, restaurant bookings and hotel occupancies have not eased meaningfully in recent weeks.

A broad series on consumer activity also offers encouragement. A group of academic economists at Harvard and Brown Universities has developed a high-frequency measure of consumer spending based on credit and debit card transactions. This measure shows that activity is holding steady rather than turning downward (chart, prior page, right).

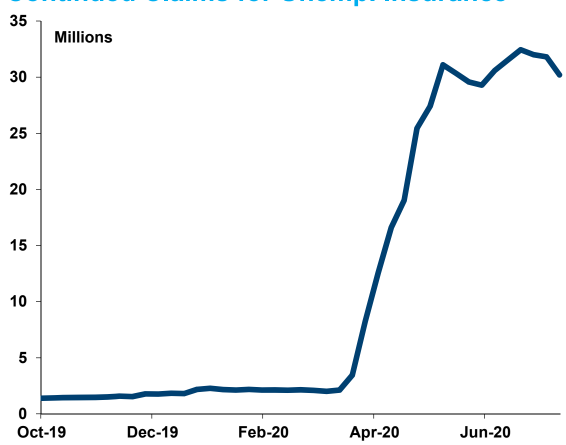
Employment-related economic indicators have been less favorable than those mentioned above, although they too are showing modest responses thus far. For example, the number of hourly employees at small businesses has softened in recent weeks, but recent results are not far outside the range that has been in place in June and early July (chart, left; the downward spikes in this series occurred around holidays: Memorial Day and Independence Day). Initial claims for unemployment insurance have picked up, but the changes are mere wiggles compared with those during the first phase of the virus; continuing claims have been moving sideways (chart, right).

Hourly Employees at Small Businesses



Source: Homebase via Bloomberg

Continued Claims for Unemp. Insurance*



** Includes regular state programs and federal programs (federal employees, newly discharged veterans, Pandemic Unemployment Assistance (PUA), Pandemic Emergency Unemployment Compensation (PEUC), and others).*

Source: Employment and Training Administration (Department of Labor) via Haver Analytics

We conclude that the economy is holding steady at the pace that emerged in June and early July. Steady activity might not seem appealing, as sideways movement will translate to no growth at some point. However, we view steady activity in the face of virus-related risks as a good performance. In addition, the shift to no growth would probably not occur until the fourth quarter, and by that time, the virus might be under better control, which will allow growth to resume.

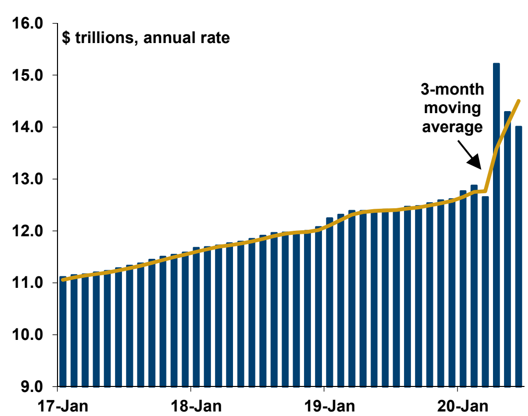
Friday's report on personal income and consumption shows why the economy is likely to expand during the third quarter despite sideways movement in recent weeks. Real consumer outlays in June totaled $12.5 trillion (annual rate), which was greater than the average of $11.8 trillion for the second quarter as a whole (pronounced weakness in April restrained the quarterly average). Even if real outlays showed no growth over the next three months, the average for Q3 would exceed that for Q2 and translate to compound annual growth of approximately 26 percent, a sizeable offset to the 34.6 percent decline in Q2 and a healthy contribution to GDP growth.

That report on income and consumption also showed that the household sector in the aggregate is in a strong financial position and therefore is likely to spend actively in the months ahead. Labor compensation is off its pre-virus levels because of elevated unemployment, but transfer payments from the federal government (primarily recovery rebate checks and unemployment benefits) have more than offset the drop in wages and salaries. The sum of wages and salaries and transfer payments surged in April and has remained elevated in May and June (chart, left). This series will ease in the months ahead in the absence of additional government support, but Congress is working on new legislation that will most likely give another boost to transfer income.

The report on income and consumption offered other interesting insights into the effect of the virus. Many observers have expressed concern about possible evictions from homes because of missed rental or mortgage payments. However, this does not seem to be a major issue at this time. Rental income has declined in the past three months, signaling some difficulty in keeping pace with obligations (chart, right), but the drop has been modest (averaging 0.3 percent per month).

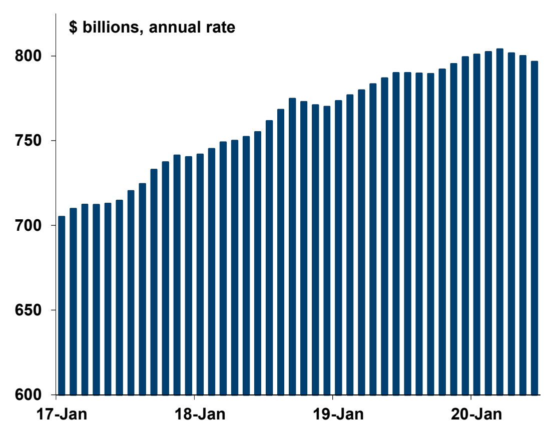
A more notable shift has occurred in investment income. The decline in interest rates has led to weak interest income, and corporations have trimmed dividends in anticipation of softer profits. All told, investment income has declined 1.3 percent in each of the past three months. Weaker investment income, though, is not likely to garner much sympathy in the media or among the general public.

Personal Income: Wages & Transfer Receipts*



** The sum of the Wages and Salaries and Personal Current Transfer Receipts components of personal income.*
Source: Bureau of Economic Analysis via Haver Analytics

Personal Income: Rental Income



Source: Bureau of Economic Analysis via Haver Analytics

Chair Powell: Still Expecting Growth; Still Highly Accommodative

Reporters at the latest press briefing of Fed Chair Jerome Powell asked several times in several different ways about growth prospects in light of the recent acceleration in Covid cases. Mr. Powell responded consistently, noting that the pace of the recovery had slowed. Interestingly, he always talked in terms of recovery and growth; he never mentioned contraction or downturn. He didn't close the door on the possibility of another drop in the economy, as he also noted (as did the FOMC's policy statement) that the outlook depends on the course of the virus. Still, he seems to have embraced the view that businesses and consumers are adapting to risks associated with the virus rather than shutting down. As a result, the economy could well remain on a growth track despite the acceleration in the spread of the virus.

While tilting to the optimistic side on the economic outlook, Chair Powell intends to run a highly accommodative monetary policy indefinitely. His most revealing comment came in response to a question on what might trigger a tightening in monetary policy. He indicated that the Fed's job at this point is to prepare for the worst and to guard against downside risks. The Fed would have no problem dealing with economic growth that was stronger than expected, but downside momentum would be troubling. He also repeated a comment made in his June briefing that officials are not thinking about interest rate increases at this time. He added that the Fed is "absolutely committed" to a highly accommodative stance until the U.S. is "well through" dealing with the virus.

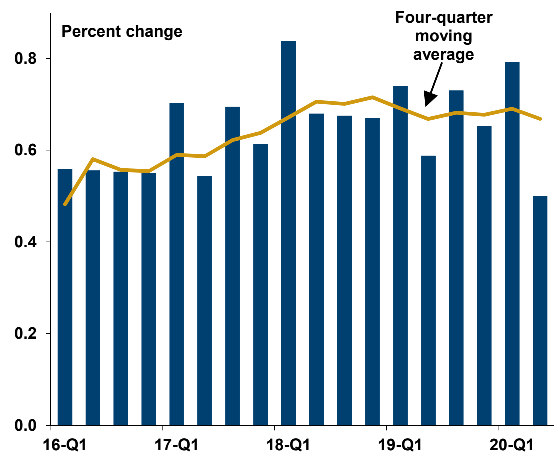
Employment Costs: Light in Q2 (Sort Of)

The series on average hourly earnings in the monthly employment report has not been providing accurate reads on recent developments in labor compensation. The measure surged in April and gave back only a portion of the reported gain in May and June. However, workers have not received a generous boost in wage rates. The increase was the result of a shift in the composition of the labor force.

Average hourly earnings, as the name implies, is a simple average of wage rates, and as such, it will fluctuate with changes in the composition of the work force: job growth in higher-paying occupations will lift the average all else equal, and firmer employment in lower-paying jobs will decrease it. In the past several months, heavy layoffs among individuals in lower-paying jobs have pushed the measure higher (smaller share of lower-wage jobs and larger share of higher-paying jobs). The year-over-year increase of 8.0 percent in April (versus 3.0 percent over the 12 months of 2019) reflected the compositional shift rather than a surge in wage rates. The recall of many of the lower-paid workers pushed the measure lower in May and June, but the year-over-year change remained firm at 5.0 percent in June.

The employment cost index provides a better view on labor compensation because it is a so-called fixed-weight measure. That is, the composition of the labor force is held steady, and as a result, it will change only with shifts in wages or benefits. This index rose 0.5 percent in the second quarter, slower than the advance of 0.8 percent in Q1 and the average of 0.7 percent over the four quarters of last year (chart).

Employment Cost Index



Source: Bureau of Labor Statistics via Haver Analytics

The slower pace seems to suggest that the soft labor market was beginning to constrain labor compensation. That view would be reinforced by the fact that the slowdown was concentrated in the service-producing sector of the economy, where job cuts were severe. However, drilling further down into the report shows that most of the softness occurred in the health-care sector. The report did not contain enough information to pinpoint the source of weakness, but we suspect it was related to the reduction in elective procedures that occurred as the pandemic spread. Quarterly increases in most other industries, including those most affected by the virus (hospitality, travel) remained within recent ranges.

Review

Week of July 27, 2020	Actual	Consensus	Comments
Durable Goods Orders (June)	**7.3%**	**6.9%**	Firm increases in durable goods orders in the past two months have retraced about half of the swoon in March and April. The increase in June was broadly based, with orders for motor vehicles leading the advance (up 85.7% after a gain of 28.8% in May). The strength in the auto sector was partly offset by another poor showing in the commercial aircraft component, which has registered net cancelations for the third time in the past four months. Excluding the noise in the transportation category, orders rose 3.3% in June and have retraced slightly more than 60% of the ground lost in March and April. Orders for nondefense capital goods other than aircraft, a series which provides insight into the outlook for capital spending by businesses, rose 3.3% after a gain of 1.6% in May. It has now retraced approximately 57% of the drop in March and April.
Consumer Confidence (July)	**92.6 (-5.7 Index Pts.)**	**95.0 (-3.1 Index Pts.)**	The dip in consumer confidence suggests that the acceleration in the number of Covid cases in July had an influence on consumer attitudes, although the effect was not pronounced. The decline represented only a partial offset to improvement in June, as the latest observation exceeded the average of 85.8 in April/May. It also was far better than the lows seen during the financial crisis (monthly low of 25.3 in February 2009 and quarterly average low of 29.9 in 2009-Q1). Still, it trailed the pre-virus average of 131.5 in January/February.
U.S. International Trade in Goods (June)	**-$70.6 Billion ($4.6 Billion Narrower Deficit)**	**-$75.4 Billion ($0.1 Billion Wider Deficit)**	Exports jumped 13.9%, easily exceeding the increase of 4.8% in imports and leaving a narrower trade deficit. The pickup in trade flows, while notable, represented only a modest offset to the sharp declines in prior months. Both export and imports remained well below pre-virus levels.
GDP (2020-Q2)	**-32.9%**	**-34.5%**	The drop in GDP growth in Q2 exceeded by a wide margin the previous record quarterly contraction (-10.0% in 1958-Q1; quarterly data beginning in 1947), and it was much worse than the softest performance during the financial crisis (-8.4% in 2008-Q4). The retreat was broadly based, although government spending and net exports made small positive contributions. Other areas were decidedly weak. Consumer spending fell 34.6% at an annual rate, influenced by both stay-at-home orders and declines in employment. Residential construction and business fixed investment also fell sharply (-38.7% annual rate and -27.0% annual rate, respectively). Inventory investment subtracted four percentage points from growth.

Review Continued

Week of July 27, 2020	Actual	Consensus	Comments
Personal Income, Consumption, and Core Price Index (June)	**-1.1%, 5.6%, 0.2%**	**-0.6%, 5.2%, 0.2%**	With payrolls improving in June, wage growth was solid (2.2%), but investment income (interest and dividends) fell 1.3% and government transfer payments continued to ease from the stimulus-related surge in April. With lockdown restrictions easing in June, consumer spending pickup up. Nominal outlays have now retraced more than 60% of the ground lost during the spring. The core PCE price index increased 0.2% for the second consecutive month after a drop of 0.4% in April, as pricing in virus-constrained areas showed signs of normalizing. The year-over-year change in the core index totaled 0.9%, off sharply from the recent high of 1.9% in February.
Employment Cost Index (2020-Q2)	**0.5%**	**0.6%**	Compensation growth in Q2 slowed from the jump of 0.8% in the first quarter and the average of 0.7% in the four quarters of last year, with the softness concentrated in the health-care sector rather than spread across the labor force. Wage growth was the most surprising element of the report, slowing to 0.4%, notably below average quarterly growth of 0.7% in 2019, and led by a drop in wages in the health-care area. Benefit growth showed a hint of upward pressure, advancing 0.8% after posting a subdued advance of 0.4% in Q1 and averaging quarterly growth of 0.6% in 2019.

Source: U.S. Census Bureau (Durable Goods Orders, U.S. International Trade in Goods); The Conference Board (Consumer Confidence); Bureau of Economic Analysis (GDP, Personal Income, Consumption, Core Prices); Bureau of Labor Statistics (Employment Cost Index) ; Consensus forecasts are from Bloomberg

Preview

Week of August 3, 2020	Projected	Comments
ISM Manufacturing Index (July) (Monday)	**52.0% (-0.6 Pct. Pt.)**	The manufacturing sector is less vulnerable to disruptions generated by the coronavirus than various service industries are, but it is certainly not immune. Thus, the acceleration in the number of Covid cases probably led to a dampening in the ISM index.
Construction Spending (June) (Monday)	**-1.0%**	A pickup in housing starts in June showed a stirring in residential building, but work on the limited number of units started in prior months will probably continue to be a drag. Business-related construction has been weak in recent months, and executives are likely to remain cautious in starting new projects because of virus-related uncertainty. Tight budgets might begin to constrain the activity of state and local governments.
Factory Orders (June) (Tuesday)	**6.0%**	A jump in factory-sector employment in June suggests that the manufacturing sector advanced for the second consecutive month, which should translate to a pickup in new orders. Indeed, the preliminary report on durable bookings showed an increase of 7.3% after an advance of 15.1% in May. The nondurable component is likely to contribute positively as well, partly because of higher prices of petroleum products, but also because of a further rebound in real activity.
Trade Balance (June) (Wednesday)	**-$49.7 Billion ($4.9 Billion Narrower Deficit)**	The already reported narrowing of $4.6 billion in the goods trade deficit is likely to account for most of the improvement in the overall trade balance (exports jumped 13.9%, exceeding the advance of 4.8% in imports; both rebounded from virus-related declines in the prior three months). The surplus in service trade is also likely to improve after declining from March through May.
ISM Nonmanufacturing Index (July) (Wednesday)	**55.0% (-2.1 Pct. Pts.)**	The service sector is especially vulnerable to virus-related constraints, and thus the pickup in the number of Covid cases since mid-June probably pushed the nonmanufacturing index lower. The business activity component could ease noticeably, as it jumped above pre-virus levels in June. A correction might be expected even if the virus had not spread.
Employment Report (July) (Friday)	**1,800,000**	Economic activity has slowed since mid-June in response to the acceleration in the number of Covid cases, but most available figures suggest a flattening rather than a decline. In addition, the number of individuals receiving unemployment insurance has moved lower since the June employment report, signaling that workers are being recalled to their jobs.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July/August 2020

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	29	30	31
DURABLE GOODS ORDERS Apr -18.3% May 15.1% June 7.3%	**S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** SA NSA Mar 0.5% 1.1% Apr 0.2% 0.8% May 0.0% 0.4% **CONFERENCE BOARD CONSUMER CONFIDENCE** May 85.9 June 98.3 July 92.6 **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS** Apr -$70.7 billion May -$75.3 billion June -$70.6 billion **ADVANCE INVENTORIES REPORT** Wholesale Retail Apr 0.2% -3.8% May -1.2% -6.2% June -2.0% -2.6% **PENDING HOMES SALES** Apr -21.8% May 44.3% June 16.6% **FOMC ANNOUNCEMENT**	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) July 04 1.310 17.304 July 11 1.308 16.151 July 18 1.422 17.018 July 25 1.434 N/A **GDP** GDP Chained Price 19-Q4 2.4% 1.4% 20-Q1 -5.0% 1.4% 20-Q2 -32.9% -1.8%	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. Cons. Core Apr 12.1% -12.9% -0.4% May -4.4% 8.5% 0.2% June -1.1% 5.6% 0.2% **EMPLOYMENT COST INDEX** Comp. Wages 19-Q4 0.7% 0.7% 20-Q1 0.8% 0.9% 20-Q2 0.5% 0.4% **CHICAGO PURCHASING MANAGERS' INDEX** Index Prices May 32.3 53.8 June 36.6 55.2 July 51.9 56.9 **REVISED CONSUMER SENTIMENT** May 72.3 June 78.1 July 72.5
3	4	5	6	7
ISM INDEX (10:00) Index Prices May 43.1 40.8 June 52.6 51.3 **July 52.0 52.0** **CONSTRUCTION SPEND. (10:00)** Apr -3.5% May -2.1% **June -1.0%** **VEHICLE SALES** May 12.3 million June 13.0 million **July 14.0 million**	**FACTORY ORDERS (10:00)** Apr -13.5% May 7.7% **June 6.0%**	**ADP EMPLOYMENT REPORT (8:15)** Private Payrolls May 3,065,000 June 2,369,000 July -- **TRADE BALANCE (8:30)** Apr -$49.8 billion May -$54.6 billion **June -$49.7 billion** **ISM NON-MFG INDEX (10:00)** Index Prices May 45.4 55.6 June 57.1 62.4 **July 55.0 58.0**	**INITIAL CLAIMS (8:30)**	**EMPLOYMENT REPORT (8:30)** Payrolls Un. Rate May 2,699,000 13.3% June 4,800,000 11.1% **July 1,800,000 10.5%** **WHOLESALE TRADE (10:00)** Inventories Sales Apr 0.2% -16.4% May -1.2% 5.4% **June -2.0% 5.0%** **CONSUMER CREDIT (3:00)** Apr -$70.2 billion May -$18.3 billion June --
10	11	12	13	14
JOLTS DATA	**NFIB SMALL BUSINESS OPTIMISM** **PPI**	**CPI** **FEDERAL BUDGET**	**INITIAL CLAIMS** **IMPORT/EXPORT PRICES**	**RETAIL SALES** **PRODUCTIVITY & COSTS** **IP & CAP-U** **CONSUMER SENTIMENT** **BUSINESS INVENTORIES**
17	18	19	20	21
EMPIRE MFG INDEX **NAHB HOUSING INDEX** **TIC DATA**	**HOUSING STARTS**	**FOMC MINUTES**	**INITIAL CLAIMS** **PHILLY FED INDEX** **LEADING INDICATORS**	**EXISTING HOME SALES**

Forecasts in Bold.

Treasury Financing

July/August 2020

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	29	30	31
27 **AUCTION RESULTS:** Rate / Cover 13-week bills 0.105% 2.48 26-week bills 0.130% 2.92 2-year notes 0.155% 2.34 5-year notes 0.288% 2.32	**AUCTION RESULTS:** Rate / Cover 42-day CMB 0.100% 3.22 120-day CMB 0.110% 3.40 7-year notes 0.446% 2.45 Spread / Cover 2-year FRNs 0.055% 3.29 **ANNOUNCE:** $30 billion 4-week bills for auction on July 30 $35 billion 8-week bills for auction on July 30 $25 billion 105-day CMBs for auction on July 29 $30 billion 154-day CMBs for auction on July 29 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**AUCTION RESULTS:** Rate / Cover 105-day CMB 0.105% 3.53 154-day CMB 0.110% 3.48	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.090% 3.09 8-week bills 0.095% 2.96 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on August 3 $30 billion 42-day CMBs for auction on August 4 $30 billion 119-day CMBs for auction on August 4 **SETTLE:** $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 120-day CMBs	**SETTLE:** $17 billion 20-year bonds $14 billion 10-year TIPS $24 billion 2-year FRNs $48 billion 2-year notes $49 billion 5-year notes $44 billion 7-year notes
3	4	5	6	7
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $30 billion 42-day CMBs $30 billion 119-day CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on August 6 $35 billion* 8-week bills for auction on August 6 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**ANNOUNCE:** $48 billion* 3-year notes for auction on August 11 $35 billion* 10-year notes for auction on August 12 $25 billion* 30-year bonds for auction on August 13	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on August 10 $34 billion* 52-week bills for auction on August 11 Settle: $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	
10	11	12	13	14
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills $48 billion* 3-year notes **ANNOUNCE:** $30 billion* 4-week bills for auction on August 13 $35 billion* 8-week bills for auction on August 13 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $35 billion* 10-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $25 billion* 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on August 17 $22 billion* 20-year bonds for auction on August 19 $8 billion* 30-year TIPS for auction on August 20 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	
17	18	19	20	21
AUCTION: $105 billion* 13-,26-week bills **SETTLE:** $48 billion* 3-year notes $35 billion* 10-year notes $25 billion* 30-year bonds	**ANNOUNCE:** $30 billion* 4-week bills for auction on August 20 $35 billion* 8-week bills for auction on August 20 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $22 billion* 20-year bonds	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $8 billion* 30-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on August 24 $22 billion* 2-year FRNs for auction on August 26 $50 billion* 2-year notes for auction on August 25 $51 billion* 5-year notes for auction on August 26 $47 billion* 7-year notes for auction on August 27 **SETTLE:** $105 billion* 13-,26-week bills	

**Estimate*